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BEFORE THE
COMMITTEE ON ENERGY AND NATURAL RESOURCES
UNITED STATES SENATE**

July 13, 2000

Thank you, Mr. Chairman and Members of the Committee, for the invitation to appear here today. I appreciate having the opportunity to share what we know about the recent sharp increases in gasoline prices, particularly in the Midwestern part of the country. I also will explain the Environmental Protection Agency's efforts, in coordination with the Department of Energy and the Federal Trade Commission, to address the situation.

Mr. Chairman, first and foremost we are very concerned that consumers receive the air quality benefits of the clean burning gasoline (also called reformulated gasoline, or RFG) program at a fair and reasonable price. In the following testimony I will show that the cost of producing RFG does not account for the extremely high price differentials we have seen in the Chicago and Milwaukee areas. As EPA reviewed the various requests for waivers from the RFG program, factors such as the pipeline, tank turnover and patents were examined. We do not believe that these factors adequately explain the price differentials that we have seen in the Chicago and Milwaukee areas.

Let me begin with a history of the RFG program.

History of RFG

When Congress passed the Clean Air Act Amendments of 1990 it put in place a number of programs to achieve cleaner motor vehicles and cleaner fuels. These programs have been highly successful in protecting public health by reducing harmful exhaust from the tailpipes of motor vehicles. In the 1990 Amendments, Congress struck a balance between vehicle and fuel emission control programs after extensive deliberation. The RFG program was designed to serve multiple national goals, including air quality improvement, enhanced energy security by extending the gasoline supply through the use of oxygenates, and encouraging the use of domestically-produced, renewable energy sources.

Congress established the overall requirements of the RFG program by identifying the specific cities in which the fuel would be required, specific performance standards, and an oxygenate requirement. The oil industry, states, oxygenate producers and other stakeholders were involved in the development of the RFG regulations in 1991 through a successful regulatory negotiation. EPA published the final regulations establishing the detailed requirements of the two-phase program in early 1994. Thus, the oil companies and other fuel providers have had six years to prepare for the second phase of the program that began this year. In addition, the oil industry has been involved in an EPA RFG implementation advisory workgroup since 1997 and at no time during those discussions did the companies raise concerns about production, supply or distribution problems that might occur.

The first phase of the federal reformulated gasoline program introduced cleaner gasoline in January 1995 primarily to help reduce vehicle emissions that cause ozone (smog) and toxic pollution in our cities. Unhealthy smog levels are a significant concern in this country, with over 100 million people living in 36 areas currently violating the 1-hour ozone standard.

The federal RFG program is required by Congress in ten metropolitan areas which have the most serious air pollution levels. Although not required to participate, some areas in the Northeast, in Kentucky, Texas and Missouri have elected to join, or "opt-in" to the RFG program as a cost-effective measure to help combat their air pollution problems. At this time, approximately 30 percent of this country's gasoline consumption is cleaner-burning reformulated gasoline.

The Clean Air Act Amendments of 1990 also required that RFG contain 2.0 percent minimum oxygen content by weight. Neither the Clean Air Act nor EPA requires the use of any specific oxygenate. Both ethanol and MTBE are used in the current RFG program, with fuel providers choosing to use MTBE in about 87 percent of the RFG. Ethanol, however, is used exclusively in RFG in the upper Midwest (Chicago and Milwaukee).

Ambient monitoring data from the first year of the RFG program (1995) confirm that RFG is working. RFG areas showed significant decreases in vehicle-related tailpipe emissions. One of the air toxics controlled by RFG is benzene, a known human carcinogen. The benzene level at air monitors in 1995, in RFG areas, showed the most dramatic declines, with a median reduction of 38 percent from the previous year. The emission reductions which can be attributed to the RFG program are the equivalent of

taking 16 million cars off the road. About 75 million people are breathing cleaner air because of cleaner burning gasoline. Since the RFG program began five years ago, it has resulted in annual reductions of smog-forming pollutants of at least 105 thousand tons, and toxic air pollutants by at least 24,000 tons.

As required by the Clean Air Act, the first phase of the RFG program began in 1995 and the second phase began in January of this year. As an example of the benefits, in Chicago, EPA estimates that the Phase II RFG program will result in annual reductions of 8,000 tons of smog-forming pollutants and 2,000 tons of toxic vehicle emissions, benefitting almost 8 million citizens in the Chicago area facing some of the worst smog pollution in the nation. This is equivalent to eliminating the emissions from 1.2 million cars in Illinois.

Administration Response to Increasing Prices

In early June, as gasoline prices rose, particularly in the Midwest, EPA and DOE invited Midwest oil refiners to a meeting in Washington, DC. Simultaneously, EPA, DOE and the Energy Information Agency (EIA) sent two teams of technical experts to the Midwest to investigate the situation and to talk to refiners, distributors, pipeline companies, jobbers, terminal operators and retail outlets. Following those meetings, which occurred on June 12 and 13, EPA Administrator Browner and DOE Secretary Richardson sent a joint letter on June 15 to Chairman Pitofsky requesting that the Federal Trade Commission conduct a full and expedited formal investigation into the pricing of RFG in Chicago and Milwaukee.

Since June 15, the wholesale price of reformulated gasoline has dropped by over 63 cents per gallon in Chicago and Milwaukee. The Oil Price Information Systems

(OPIS) has reported that the wholesale price differential between RFG and conventional gasoline in nearby cities has dropped to less than 1 cent a gallon in Chicago and 8 cents a gallon at Milwaukee terminals.

In our discussions, representatives of oil companies listed a number of factors which they believed contributed to the price differential between RFG and conventional gasoline in the Midwest. These included: the additional cost of producing RFG phase II, temporary shutdown of the Explorer Pipeline, the difficulty with replacing winter gas with summer blends (draining tanks), and the Unocal patent. I would now like to discuss each of these factors and show why EPA believes even taken together they do not account for the high gasoline prices.

Production Costs for RFG Do Not Explain Price Increases

As I stated earlier, we are very concerned that consumers receive the benefits of the RFG program at a fair price. Across the country hundreds of communities are benefitting from RFG II for pennies per gallon. In fact, this Monday (July 10), the average retail price of conventional gasoline across the country was \$1.57 per gallon. EPA has calculated, based on EIA and OPIS surveys, that the average retail price for RFG II everywhere except in Chicago and Milwaukee was \$1.63 per gallon, while the average retail price in Chicago and Milwaukee was \$1.80 per gallon.

Mr. Chairman, two recent CRS reports have assessed increases in Midwestern gasoline prices. EPA disagrees with the CRS findings. CRS did not investigate RFG production costs, but rather focused on the price differential between RFG in the Midwest and other parts of the country. The CRS analysis was based on prices of gasoline in mid-June. As I mentioned, wholesale prices in Chicago and Milwaukee

have dropped about 63 cents per gallon since June 15. Certainly, this dramatic change must say something about the cause for previous price differentials. Manufacturing costs have not changed. Ethanol use has not changed. The pipeline capabilities have not changed. Nor has the Unocal patent gone away. And yet the differential is now only pennies. The CRS analysis fails to provide an explanation. In addition, the updated CRS report acknowledges that “the price increases -- driven by supply-demand pull -- are so large and out of proportion to any likely higher manufacturing costs associated with the RFG sold there that it is unlikely that manufacturing-related ‘cost push’ would be a factor.”

EPA strongly disagrees that the RFG program is responsible for increases in gasoline prices in the Midwest. In fact, EPA’s estimates of the average cost for the production of Phase II RFG range from 4 to 8 cents more per gallon than conventional gasoline (with the use of either ethanol or other oxygenates). Several studies agree with EPA’s estimates of the average costs:

Analysis by Bonner and Moore Management Science, a nationally recognized firm that specializes in refinery cost analysis, estimated that RFG I would add 3-5 cents more per gallon to the average cost compared to conventional gasoline. Subsequent studies by Bonner and Moore and Oak Ridge National Laboratory estimated that RFG II would add 1-2 cents to the average cost of RFG I or 4-7 cents to the average cost of conventional gasoline. Oak Ridge National Laboratory estimated that the average added cost of blending ethanol into RFG II as compared to RFG I was about 1 cent more per gallon.

As I have already stated, in recent weeks, the wholesale price differential between RFG and CG has dropped dramatically in the Chicago/Milwaukee area. We do know that this differential is now in line with differentials observed in other parts of the country. EPA does not believe that the cost of complying with RFG regulations accounts for the extremely high price differentials we have seen in the Chicago-Milwaukee areas.

Temporary Shutdown of Explorer Pipeline

EPA investigated the situation with the Explorer pipeline to respond to the waiver requests we received and would like to share our findings. The Explorer pipeline has historically provided 10 to 15 percent of the RFG supply for the Chicago/Milwaukee area. The outage of the pipeline in mid-March meant a loss of 108,000 barrels of RFG destined for the Chicago area. Chicago consumes about 200,000 barrels of gasoline a day. Thus, the RFG lost due to the Explorer pipeline outage was less than one day's RFG needs for Chicago. Since mid-March, the Explorer pipeline from Houston to Tulsa has been running at 90 percent capacity, while the pipeline north of Tulsa to the Midwest has been capable of operating at 100 percent capacity. The supply of RFG to the Midwest has increased this year over last year and, in fact, for the month of June refiners expected to supply 650,000 more barrels of RFG this year than last year. The Explorer pipeline company has informed us that more RFG could be sent if the companies elected to do so. For example, the pipeline company has informed us that, beginning earlier this month deliveries of RFG to Chicago have increased by approximately 100,000 barrels per ten day cycle.

Tank Turnover

Tank turnover refers to the need to replace winter gasoline in terminal storage tanks with summer blends. Fuel providers have been doing this for over ten years to comply with summertime gasoline volatility requirements. This normally begins in April and, as required by regulation, the tanks at terminals must all meet summertime RFG requirements as of May 1st.

Unocal Patent

EPA has heard comments as to the impact of the Unocal patent. While we understand that this matter may be in litigation, the refiners have told us in meetings with them that they are able to produce RFG that is not subject to the patent. In our discussions with refiners and with Unocal, no one has identified any cost or supply issues related to the patent that could in any way explain the price increases for RFG that we have seen in the Midwest over the last two months.

Waiver Issues

In recent weeks there have been many calls for EPA to waive the RFG Phase II requirements in Milwaukee and Chicago. The RFG regulations provide for an administrative waiver under very limited circumstances -- extreme and unusual circumstances, such as Acts of God or natural disaster, where the refiner or importer is unable to comply with the RFG requirements despite its exercise of due diligence and planning. The various criteria for an administrative waiver under the regulations have not been met in the Milwaukee or Chicago area, so EPA has treated all of the requests for a waiver as requests for enforcement discretion. Enforcement discretion is normally used in situations such as occurred in St. Louis early this spring, where the short term

shut down of the Explorer pipeline led to actual and acute shortages. The pipeline supplies on average 70 percent of fuel delivered to St. Louis.

For Chicago and Milwaukee the supply of RFG continues to be adequate and prices are going down. All refiners have strongly recommended that EPA not grant RFG waivers. It is highly uncertain what effect a waiver would have on supply and prices. Refiners would need to make adjustments and switch gears, imposing short term costs and the possibility of supply problems. No RFG Phase I is currently available, and supplies of conventional gasoline are tight as well. Waiving the RFG Phase II requirements under these kinds of circumstances could exacerbate the supply and price situation in the Midwest, for both RFG and conventional gasoline.

VOC Adjustment Proposal

On June 30th, EPA proposed an adjustment to the VOC performance standard under Phase II of the Reformulated Gasoline program for blends that contain 10 volume percent ethanol. This proposal would increase refiner flexibility to reduce MTBE use by making ethanol use less costly. This regulatory change responds to a 1999 report by the National Research Council which suggested that EPA recognize the contribution of CO to ozone formulation in assessments of the effects of RFG. The proposal recognizes the CO benefits from the use of oxygenates in the RFG program by considering the offsetting CO reductions for the use of ethanol in allowing an adjustment to the VOC performance standard. There will be a sixty-day comment period on the proposal. The proposal also solicits comment on a study by the Illinois Department of the Environment that suggests a much larger adjustment based on reactivity factors.

Conclusion

In closing, I would like to reiterate the following points:

- Clean burning RFG II is providing public health benefits to almost 75 million citizens nationally and nearly 8 million in the Chicago area alone.
- EPA believes the cost of producing RFG II does not account for the extreme prices being paid by Midwest consumers. The pipeline disruption, the tankage issue, the Unocal patent and its implications, as well as ethanol use, have all been analyzed. EPA does not believe that these factors adequately explain the price increases we have seen in recent weeks.
- We are concerned that consumers are paying these high prices for RFG II.

This concludes my prepared statement. I would be pleased to answer any questions that you may have.